EXECUTIVE BOARD MEETING

SM/23/129
Correction 1

June 9, 2023

To: Members of the Executive Board

From: The Secretary

Subject: **United States—Staff Report for the 2023 Article IV Consultation**

Board Action:	The attached corrections to SM/23/129 (5/30/23) have been provided by the staff:
Evident Ambiguity	**Page 31**
Questions:	Mr. Chalk, WHD (ext. 34506) Ms. Weber, EUR (ext. 34013)

that the bank's management had received several warnings linked to the bank's liquidity stress testing, contingency funding, and risk management and modeling practices. Despite this, supervisory actions did not prevent the bank from continuing to grow rapidly and did not precipitate fundamental changes to the bank's operations. Moreover, the SVB episode raises additional questions about the effectiveness of the discount window in providing liquidity under stress (potentially because of stigma and/or due to the margins applied to collateral pledged at the window).

47. The review undertaken by the Federal Reserve sheds light on supervisory failures and will help inform a needed recalibration of financial regulations and supervisory practices. Prudential requirements should be made more stringent for mid-sized banks, subjecting them to similar requirements as large banks. Specific changes for non-internationally active banks (i.e., Category III and IV firms) should include (i) subjecting them to regular stress testing as part of the annual supervisory stress testing process; and (ii) aligning their capital and liquidity requirements with the Basel framework (including applying coverage of the liquidity coverage ratio and the net stable funding ratio). More explicit rules and processes should be instituted to escalate supervisory actions in the event that banks do not respond in a timely way to address supervisory warnings. In addition, the practice of not applying margins to collateral at the discount window should be viewed as an extraordinary step and should be discontinued in March 2024 (i.e., when the Bank Term Funding Program is scheduled to expire).

48. There would be benefit in strengthening the stress testing framework and addressing shortcomings in the prudential frameworks for assessing banks' exposure to interest rate risk. Exemptions for medium-sized banks from annual supervisory stress test introduced in 2018, in combination with rapid balance sheet growth, meant that SVB was not subject to stress testing despite having assets of US$221 billion by end-2022. However, even if the Fed's stress test and capital planning exercise had been applied, it is unclear that the underlying vulnerabilities would have been revealed. The Dodd-Frank stress tests are typically focused on negative macroeconomic scenarios that result in a decline, not increase, in interest rates. Furthermore, the Basel methodology to identify banks with excessive interest rate risk exposure, and then subject them to more intensive supervision, has not been adopted by the U.S. There is also no standardized disclosure requirement on interest rate risk. It would, therefore, be beneficial to examine a broader range of scenarios in stress testing. A more methodical process is needed to assess banks' exposure to interest rate risk—in both the available for sale and the hold to maturity portfolios—and have a supervisory response in cases where these risks are seen to be building. Undertaking stringent integrated solvency-liquidity stress tests should be a key component of the policy response arising from recent events.

49. High leverage, liquidity and duration mismatches, and interconnectedness between non-bank financial institutions and the banks pose additional risks.[14] Flows into money market funds have accelerated following the regional bank failures and there are risks that banks become

[14] The FSOC has released for public comment (i) a proposed analytic framework on how FSOC intends to identify, assess, and mitigate risks to financial stability as well as (ii) a process to remove hurdles ~~in the process~~ to designating~~e~~ nonbank entities as being systemically important and to ensure that the designation process is rigorous and transparent.